3 December 2004

Eurostat Financial Accounts Working Group

Comment to the EDG Final Report of 14 October 2004
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Contribution to the EDG on Non Performing Loans

Introduction

1. On 17 November the Eurostat *Task Force on the SNA review (financial accounts and government finance statistics)* and thereafter on 18 November the *Financial Accounts Working Group* (FAWG) met in Luxembourg and examined the Final Report of the Moderator of the Electronic Discussion Groups (EDG) on non performing loans. This Final Report[1] is scheduled to be discussed for decision during the Advisory Expert Group (AEG) December 2004 meeting.[2]

2. Following the discussion, a written consultation on the approval of the text below was launched on 23 November by Eurostat. By 3 December 2004, 22 national institutions (national institutes of statistics—NSI or national central banks—NCB)[3] provided an answer as well as the ECB.

3. It is the opinion of the FAWG that the appropriate statistical treatment of non performing loans ought to take into account additional considerations, notably presented in this contribution, not yet fully treated by the Moderator's Report. **It is suggested that it is premature to come to closure, and that, even though there is some likelihood that the final outcome would remain unchanged—with support in many constituencies—, more time is needed to ensure "due process".** It has recently been demonstrated that not everybody interprets "market value" or "market-equivalent value" in the same way. Thus, when the Moderator July 2004 Questionnaire was answered, some countries/respondents appear to have interpreted this concept as "fair value" and others as "nominal less provisions". The FAWG considers that such confusion muddies the meaning of the replies.

[1] http://www.imf.org/forum/Message2.asp?forumid=9&messageid=428&threadid=428
[2] Activities of the TFHPSA are observable at: http://www.imf.org/external/np/sta/npl/eng/discuss/index.htm
[3] BE (NCB), DE (NSI, NCB), DK (NSI), EL (NCB), EE (NSI), ES (NCB), FR (NCB), IT (NSI, NCB), NL (NSI), NO (NCB), AT (NSI, NCB), PT (NCB), SK (NSI, MOF), FI (NSI, NCB), SE (NSI), UK (NSI, NCB).

Full market/fair valuation

4. **The FAWG nearly unanimously does not agree at this stage with the Final Report statement (Executive summary bullet 6) that "*there is a broad consensus that the concept of market value could also apply to loans*"[4].** Instead the FAWG would like to remind that the European Union senior advisory body on statistics, the CMFB (Committee on Monetary, Financial and Balance of payment statistics), took position against IASB's proposals of full fair valuation of (some) loans. See its opinion (notably para 12 and 14) of July 7, 2004 on the Fair value option in IAS 39.[5] There seems to be near unanimous view in Europe at this stage that loans that are not impaired should be recorded at their nominal value. In this context, the statement of the EDG Final Report would seem hazardous[6].

5. This EDG statement is seemingly based on the responses to the Moderator July 2004 Questionnaire, which showed near unanimous support for Option 2 to 4. However, it is a matter of interpretation if those options where referring to full fair valuation or not.

Misleading Option 4 of the Moderator Questionnaire

6. The FAWG noted that the Final Report dated October 14 distinguishes three fundamental valuation options: "nominal valuation", "nominal valuation adjusted for credit risk" and "market valuation". It considered it a major improvement on the draft Report circulated in August 2004 and on the Moderator Questionnaire of July 2004. None of those two latter documents distinguished those three options.

7. In this context, the FAWG observed that the option "nominal valuation adjusted for credit risk" corresponds to the valuation universally followed on the asset side in the accounting community, a point insufficiently referred to in the Final Report. It is worth noting that the Final Report mentions at times "market-equivalent" valuations and at other times "market" valuations, without defining the meaning of the former, and using it in seemingly contradictory ways. In particular, Paragraph 9 of the Final Report would suggest that "nominal value adjusted for credit risk" is conceived as being different from market-equivalent, whereas Option 4 of the Moderator Questionnaire included "nominal values net of expected losses" (which seems to be the same as the "nominal valuation adjusted for credit risk").

8. **In this context, the FAWG considers that the Moderator Questionnaire[7] of July 2004 was structured in a way that could not allow respondents to answer appropriately, and the Moderator to conclude decisively**.

9. The FAWG noted that some respondents to the July Questionnaire, either in support of Option 2 or Option 4 interpreted market-equivalent as nominal value adjusted for credit risk (i.e., nominal value less bad loans provisions/allowances), while others interpreted those options in terms of fair valuation.

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[4] It is assumed here that the text of the Final Report refers here to the statistical community.

[5] http://www.cmfb.org/pdf/CMFB%20opinion%20on%20FVA%20under%20IAS%2039-final.pdf

[6] This point had already been flagged to the EDG Moderator in a EDG contribution provided on October 10, 2004. See: http://www.imf.org/forum/Message2.asp?forumid=9&messageid=437&threadid=425

[7] Which encompassed only one question proposing "4 options" and was supported by a meagre 3-page document.

10. **In addition to the four options proposed, the FAWG considers that the Questionnaire should have proposed at least a fifth option; or to be more consistent across options, the Questionnaire should have split each of those options between a variant retaining fair value and a variant retaining nominal value adjusted for credit risk (i.e., nominal value net of bad loans provisions/allowances)**—so respondents should have been requested to answer:

    1. Leave SNA as it is;
    2a. Keep nominal value, but with mandatory memorandum items on fair value (i.e., leave SNA core unchanged)*;
    2b. Keep nominal value, but with mandatory memorandum items on nominal value adjusted for credit risk (i.e., less bad loans provisions/allowances—"net value") (i.e., leave SNA core unchanged)*;
    3a. Fair value in creditor accounts, nominal value in debtor accounts;
    3b. Nominal value adjusted for credit risk (i.e., less bad loans provisions/allowances—"net value") in creditor accounts, nominal value in debtor accounts;
    4a. Fair value for both creditor and debtor, but with mandatory memorandum items on nominal value and interest arrears;
    4b. Nominal value adjusted for credit risk (i.e., net of bad loans allowances/provisions—"net value") for both creditor and debtor, but with mandatory memorandum items on nominal value and interest arrears.[8]

    ***** or alternatively information on nonperforming loans***

11. The FAWG took note that this fundamental comment had already been made at the OECD National Accounts Experts Group (October 2004).

12. Option 4b corresponds to the valuation universally followed by the accounting profession for representing holdings of loans when measuring the shareholder equity. Option 4b however applies such valuation also to the liability side of institutional sectors, similar to the valuation convention followed in 1993 SNA for securities on their liability side. The FAWG observed that microeconomic reasons may nonetheless provide justifications why debtor valuation of securities at market value is justified whilst that for loan would not, as debtors' liabilities may be reduced, even though they would not be aware of that. In addition Option 4b creates significant source data difficulties to produce a value for loans, when liabilities of resident units, in the international investment position.

13. The FAWG also recognized that the practice of compiling financial accounts showed that the accounts of the debtors and the creditors rarely matched **ex-ante**. The FAWG noted that whilst nominal value did not guarantee symmetry (in so far as the creditor may have written off a claim whilst still existing in the account of the debtor; or alternatively the debtor may not record a liability where the creditor does), it was likely that such differences in concept would be limited in terms of amounts. More in general, it is argued that the way parties recognize or value instruments (more or less consistently between them) is not an overruling argument for or against a conceptual recording in financial accounts. SNA 12.51 as well contributors to the EDG[9] also

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[8] It is worth noting that the proposed new treatment of terminal costs on non financial assets—e.g., decommissioning of nuclear reactors— suggests deducting from the value of the asset the provisions for that costs, gradually over the life of the asset.
[9] See paragraph 25 at: http://www.imf.org/forum/Message2.asp?forumid=9&messageid=424&threadid=424

suggest that the time of write-off of the asset in the accounts of the creditor may be in concept the appropriate moment for derecognising the loan in SNA/ESA.

14. The FAWG also noted that in practice differences are often important, and financial accountants commonly use the information provided by the accounts of creditors. It nonetheless emphasized the attachment of financial accountant to maintaining **ex-post** symmetry in the financial accounts and the national accounts.

Write-offs or write-downs

15. The FAWG noted that the ESA 1995 references (ESA 5.16 and ESA 6.27d) to write-downs as being other changes in volume (as pointed out in the ECB contribution to the EDG—Point 5 bullet 2 of the Executive Summary) is a matter of concern and requires clarification, to the extent that write-downs are construed to be generally/often understood as increases in the allowances/provisions for bad debt (in the context where instruments are not carried at market value). GFSM 2001 takes the same position it would seem (Appendix II para 12). IASs more commonly refer to "impairment losses", instead of allowances/provisions, but note that such impairment losses are sometimes called "provisions"[10]. Others suggest that a write-down is a partial write-off and others that a write-off is simply the last of the write-downs.

16. Though SNA 1993 references to write-downs are more episodic, **ESA/SNA would need a clarification of language in this respect and clear definitions of write-offs and of write-downs should be included in the revised SNA, taking benefit from consolidated accounting practices.** Annex I suggests a tentative view of what may distinguish write-offs from write-downs.

17. Having in mind the importance of international comparability of statistics, one issue that attracted little interest so far is whether business accounting practices are more homogenous worldwide with respect to time of write-offs or with respect to time of write-downs. The obligation of accountants to faithfully represent the shareholder equity would suggest write-down policies are more consistent. However, statisticians commonly assume the reverse[11]. **This would need to be documented by the EDG**.

Valuation of taxes receivables (AF.7)

18. There is a wide consensus within the Task Force on Harmonization of Public Sector Accounting (TFHPSA)[12] that SNA 7.60[13] should be reinforced, to aim at adopting an approach similar to that of ESA 1995. ESA 1995, as amended by European

[10] See IFS 2003, page 37-10: paragraph 7 of the Scope section to IAS 37.

[11] See O'Connor's EDG contribution (June 25, 2004): *" During the SNA revision process (discussed in 1988 in Washington, 1990 in Washington, and 1991 in Harare) we opted for nominal (or principal) value, because there was no clear, unambiguous, and internationally comparable way of reducing the nominal value of nonperforming loans, except where the loans were de facto traded. That is still the case today, but there has been much more work done (Basel Committee) on defining nonperforming loans and standardizing treatments. Therefore, there is more basis for determining comparable memorandum items that the analyst (but not the compiler) can use to reduce nominal value"*. See at: http://www.imf.org/forum/Message2.asp?forumid=9&messageid=417&threadid=412

[12] See minutes of the September 2004 meeting at: http://www.imf.org/external/np/sta/tfhpsa/2004/092404.pdf

[13] "*In some countries, and for some taxes, the amounts of taxes may diverge substantially and systematically from the amounts due to be paid. (…) In such cases, it may be preferable to ignore unpaid liabilities and confine the measurement of taxes within the System to those actually paid. Nevertheless, the taxes actually paid should still be recorded on an accrual basis at the times which the events took place which gave the rise to the liabilities.*"

Regulations 2516/2000 and 995/2001, values taxes accrued by excluding the "amounts…unlikely to be collected" (ESA 1.57). GFSM 2001 takes a similar view. This allows aligning on the international accounting practices, where gross amounts of taxes owed are provisioned by an estimate of likely nonrecoverables (based on experience). The question is being discussed, for submission to the AEG, by the TFHPSA[14].

19. However, this would suppose that the amount of tax receivable to be recognized in the SNA balance sheet would be the provisioned amount, i.e., the written-down amount = the net amount. Hence, for other receivables/payables related to taxes, the SNA would (as ESA 1995 does already) depart from the all-or-nothing approach followed for loans. **This issue of consistency[15] across instruments is not mentioned in the Final Report (if only to acknowledge reasons for differences in valuation between AF.4 and AF.7),** although this was raised at the TFHPSA meeting in September 2004 and at the OECD National Account Experts Group in October 2004.

Other impacts on government accounts

20. The FAWG signals[16] that while the question of the impact on government accounts has been raised by prominent EDG contributors, notably: Kevin O'Connor,[17] François Lequiller,[18] the Final Report contains hardly any reference. Various members noted the impact on budgetary statistics of valuation loans for both the general government *net worth* (B.90) and the *net lending / net borrowing* (B.9).

21. Among the questions to be enquired in the EDG Moderator report and of major interest to the FAWG is the appropriate time of derecognition of loans in ESA/SNA (construed to be the time of write-off). This is an unresolved issue, which is of significant importance for government finance statistics. Governments can have an incentive to time their write-off to achieve a statistical effect, instead of to reflect the economic reality, whereas the timing of the write-downs is generally dictated by prudential or general accounting principles. Governments can even sometimes time their cancellations and opt to delay needed recapitalization operations or internationally coordinated debt relief (Paris Club).

22. More in general, properly accounting for debt reschedulings is of importance and one principal consideration lays on the valuation of the instrument itself. There also exists a noticeable activity of secondary market quotations of Paris Club (as well as London Club) debts, and government sometimes dispose of claims by way of secondary market transactions, or structured deals. Appropriately accounting for those events is important and **those issues need to be taken into account by the EDG**. They also relate to AEG item 43.b "Interest at concessional rates". There is a need of further clarification of the rules for recording of write-offs, write-downs, debt cancellations (the time of recording, the amount of recording and the impact on the deficit).

[14] See: http://www.imf.org/external/np/sta/tfhpsa/index.htm
[15] Current issue under ESA and issue expected to arise in future under a Reviewed SNA.
[16] Those issues have been flagged in a Contribution by the Eurostat *Task Force on the SNA review (financial accounts and government finance statistics)* dated September 21, 2004—see: http://www.imf.org/forum/Message2.asp?forumid=9&messageid=426&threadid=425.
Surprisingly, the Final Report does not refer to this contribution at all.
[17] http://www.imf.org/forum/Message2.asp?forumid=9&messageid=417&threadid=412
[18] http://www.imf.org/forum/Message2.asp?forumid=9&messageid=422&threadid=412

23. There may also be consistency difficulties between the EDG Final Report and the Eurostat *ESA 1995 Manual on Government Deficit and Debt* view of how to account for loans purchased at above market price in the case of restructuring agencies.[19] **This would need to be further analysed** (point raised notably by François Lequiller in his EDG contribution: *Nonperforming loans: a contribution in favour of option 3*)[20].

Property income on non performing loans

24. The Final Report of the EDG avoids mentioning the treatment of property income on non performing loans. The issue is important and relates to whether the loan impairment should lead to a change in loan value, and whether such a change is a volume change or a price change. **The EDG would need to address the issue**. Consistency between stocks of instruments and the associated property income is important, and questions cannot be treated in isolation. As an example, a preference to record interest only on the recoverable component of the loan might be considered as a source of arguments in favour of the Option 4b. The issue also relates to AEG item 38.c "debt in arrears".

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[19] Called "defeasance structures" in the *ESA 1995 Manual on Government Deficit and Debt*, and sometimes referred to as "bad banks" (in the press).
[20] http://www.imf.org/forum/Message2.asp?forumid=9&messageid=422&threadid=412

Annex I

1. The presentation of financial statements often uses the practice of showing 3 columns on the assets side of the balance sheet: (1) gross value, (2) amortization/provisions/allowances/impairment losses, and (3) net values—i.e., net in the sense of (3)=(1)-(2). Note that this presentation is relaxed when assets are valued at market values. To some extent, the two first columns should be seen as "memorandum items" to the balance sheet. Therefore, the reference to "book value" of assets should be more conceived as the net amounts.

Gross Values	amortizations provisions allowances impairment losses	Balance sheet			
		assets		liabilities	
(1)	(2)	(3)			
200	140	60	Buildings	Shareholder equity	300
1050	110	940	Loans	Debts	700
		1000	Total	Total	1000

2. Additions to amortization/provisions/allowances/impairment losses reduce shareholder equity[21] and are charged in the profit and loss.

3. Fixed assets are thereby amortized and shown in the balance sheet net of amortization. Similarly, impaired loans (or other assets not valued at market) are marked down by way of adding to the provisions/allowances/impairment losses.

4. When the fixed asset is decommissioned or when the loan is deemed irrecoverable, gross amounts are deleted. It is likely that such events impact neither shareholder equity nor the profit and loss of the period, because the assets in question will have been fully amortized or provisioned before then.

5. In this context:
    a. A **write-down** is a reduction of the net value by way of adding to amortization/provisions/allowances/impairment losses;
    b. A **write-off** is a reduction of the gross value;
    c. A **partial write-off** is when the gross value is deleted in part instead of in full. It differs from a write-down.

[21] Shareholder equity corresponds to the net value of the company, where assets and liabilities are values at book value and having in mind that shares issued are not liabilities. Shareholder equity is similar in concept to SNA/ESA "Own funds" (i.e., assets minus liabilities, excluding equity liabilities), rather that "Net worth". Net worth (B.90) is equal to assets minus liabilities. As ESA/SNA treat equity issues as liabilities of the issuer, the ESA/SNA net worth is a residual balance. ESA 7.05 defines Own funds (as B.90+AF.5 liabilities), whilst SNA does not. In business parlance, net worth corresponds to shareholder equity; this is extremely confusing because the statistical equivalent is Own funds, instead of Net worth. It is very common to observe statisticians borrowing common business terminology and using the term Net worth to mean Own funds.